89-675

No. ___

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

AMBASE CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Whether—in view of decisions of this Court holding that the courts have a "duty" to give effect, if possible, to every provision of a statute—it was permissible for the court of appeals to uphold Respondent's denial of Petitioner's claimed tax deductions without responding, in *any* way, to Petitioner's *uncontested* assertion that Respondent's position made a complete "dead letter" of the special statutory deduction provision that was the cornerstone of Petitioner's argument.

2. Whether—in view of (i) decisions holding that section 446(b) of the Internal Revenue Code may not be used to disallow deductions "specifically authorized" by other sections of the Code, and (ii) considerations regarding the proper allocation of governmental responsibilities for enacting, interpreting, and enforcing the tax law—it was permissible for the court of appeals to decide this case under section 446(b) without deciding the meaning of the special statutory deduction provisions on which Petitioner relied.

Rule 28.1 Statement

This Petition for a Writ of Certiorari is filed on behalf of Petitioner, AmBase Corporation. Petitioner's subsidiaries (other than wholly-owned subsidiaries) and affiliates are:

City Ormond Management Company
Enerquest Corporation of N.Y.
Realquest of Michigan, Inc.
Realquest Corporation of Westland
Realquest Servicing Corporation

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AMBASE CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner, AmBase Corporation, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.[1]

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-12a)[2] is reported *sub nom. Home Group, Inc. v. Commissioner*, 875 F.2d 377 (2d Cir. 1989). The opinion of

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[1] The Home Group, Inc., the appellant below, has changed its name to AmBase Corporation. Accordingly, AmBase Corporation is the name of the Petitioner here.

[2] "App." references are to the Appendix to this Petition.

the United States Tax Court (App. 13a-29a) is unofficially reported *sub nom. City Investing Company v. Commissioner*, 52 T.C.M. 1422 (1987).

JURISDICTION

The judgment of the court of appeals was filed on May 11, 1989. (App. 31a-32a) A timely filed petition for rehearing was denied on July 27, 1989. (App. 33a-34a) The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 446(b) of the Internal Revenue Code of 1954 (the "Code") provides that if the method of accounting used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

The underlying statutory issue below, for which Petitioner does not seek review by this Court, involved sections 832 and 162 of the Code.

Section 832(a) provides that, in the case of an insurance company subject to tax under section 831, the term "taxable income" means gross income as defined in section 832(b) less the deductions allowed by section 832(c).

Section 832(b)(3) provides that the "underwriting income" component of gross income consists of "the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred."

The term "expenses incurred" is defined in section 832(b)(6), as follows:

> (6) EXPENSES INCURRED.—The term "expenses incurred" means all expenses shown on the annual statement approved by the National Association of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For purposes of this subchapter, the term "expenses unpaid" shall not include any unpaid loss adjustment expenses shown on the annual statement, but such unpaid loss adjustment expenses shall be included in unpaid losses. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

Section 832(c) enumerates thirteen categories of allowable deductions. Subsection 832(c)(1) provides:

> In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:
>
> > (1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses) . . . .

Finally, section 162 allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year."

STATEMENT OF THE CASE

During the years at issue, 1968-1970, Petitioner and The Home Insurance Company ("Home") joined in the filing of a consolidated federal income tax return.[3] (App. 2a n.1, 13a) Home was incorporated in New York in 1853 and is nationally engaged in the property and casualty insurance business. (App. 2a, 3a, 13a-14a)[4]

As required by state law, Home has filed annually a statement of its financial condition (the "annual statement") on forms approved by the National Association of Insurance Commissioners ("NAIC"). At all times since at least 1920, NAIC has required that the annual statement be prepared using the earned and incurred method of accounting (known in the insurance industry and hereinafter referred to as the "Statutory Method"). (App. 4a, 14a and n.5)

Prior to and during the taxable years at issue, Home issued numerous policies that permitted the insured to pay premiums in installments. (App. 2a, 3a, 14a-15a) Policies of this type are hereinafter referred to as "installment policies." Installment premiums that became due and payable on an installment policy after the end of the calendar year in which the installment policy was issued are referred to as "deferred premium installments." (Br. 4)

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[3] For convenience, all references throughout the Petition will be to Home rather than to Petitioner.

[4] All references to Home for periods after 1929 also apply to Home's wholly-owned subsidiary, The Home Indemnity Company, which has been engaged in the property and casualty insurance business since 1930. (App. 2a n.1, 13a-14a)

During 1968-1970, Home sold insurance policies primarily through a network of independent agents. The agents were entitled to commissions equal to a specified percentage of the premiums due on the policies. Premiums were customarily paid by the insured parties to the agents who deducted their commissions and remitted the balance to Home. (App. 2a, 3a, 15a)

As is common in the industry, Home filed NAIC annual statements in which the deferred premium installments were recorded as "premiums written" in the year in which the related installment policy was issued. In accordance with NAIC requirements, all agents' commissions related to the installment policy were shown as expenses on the annual statement for the same year in which the deferred premium installments were recorded as premiums written. (App. 2a-3a, 4a, 14a n.5, 16a-17a and n.11)

For federal income tax purposes, Home was a property and casualty insurance company subject to tax under section 831 of the Code. (App. 6a, 14a n.3) For the taxable years 1968-1970, Home computed its taxable income in accordance with the NAIC Statutory Method used on the annual statements that Home filed for those years. (App. 4a, 14a) In accordance with the rules used to determine underwriting income under the Statutory Method (see Br. at 24 n.14),[5] federal taxable income is based on "premiums earned" (as defined in section 832(b)(4) of the Code) rather

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[5] "Br.," "Rep. Br.," and "Pet. Reh." references are to Home's appellate brief, reply brief, and Petition for Rehearing, respectively, which have been lodged with the Clerk of this Court. "Comm. Br." refers to Respondent's appellate brief which also has been lodged with the Clerk.

than "premiums written." Pursuant to section 832(b)(4), Home did not include the deferred premium installments in taxable income. (App. 4a, 16a-17a) However, Home deducted currently the entire commission expense shown on the annual statement, including the unpaid portion attributable to deferred premium installments. (App. 4a, 17a) On audit, Respondent (hereinafter the "Commissioner") disallowed deductions claimed for the unpaid commission expense attributable to deferred premium installments. (App. 3a, 4a)

In the courts below, Home contended, under the provisions of section 832 of the Code, that its commission expense must be deducted in the year in which it is shown on the NAIC annual statement, even though that treatment produces a mismatching of income and expenses (as Home conceded it would here). (App. 7a-8a, 19a-20a, 22a; Br. 11, 15-22, 33-36; Rep. Br. 14-16) Home based its position on section 832(b)(6), which defines "expenses incurred" to include all expenses shown on the annual statement, and section 832(c)(1), which allows a deduction for "all ordinary and necessary expenses incurred, as provided in section 162." Home argued that the words "expenses incurred" in section 832(c)(1) refer back to "expenses incurred" as just defined in section 832(b)(6). Thus, Home argued that section 832(c)(1) allows a deduction for all "expenses incurred," as defined in section 832(b)(6), that are "ordinary and necessary . . . as provided in section 162" (as the commissions involved here concededly are). (App. 7a-8a; Br. 6, 15-22; Rep. Br. 3, 13)[6]

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[6] Home pointed out that Rev. Rul. 55-580, 1955-2 C.B. 282,

As the principal support for its interpretation of the statute, Home contended that *any* other interpretation would make a *complete* "dead letter" of section 832(b)(6) by leaving that section with absolutely no function at all. (App. 8a; Br. 17-19; Rep. Br. 3; Pet. Reh. 1-4) This contention will hereinafter be referred to as Home's "dead letter" argument.

Home further argued that the legislative histories of the Revenue Act of 1921 and the Tax Reform Act of 1986 unequivocally establish that Congress intended in 1921 to adopt a special rule for determining when the expenses of a property and casualty company are deductible, and acted on the belief that it had done so when it amended certain related provisions in 1986. (App. 8a; Br. 7-9, 22-31; Rep. Br. 16-21) Home pointed out to the court of appeals that the action Congress took in 1986 for the avowed purpose of producing a "better matching" of income and expense was predicated on the relevant committees' stated belief that under the then current law (*i.e.*, the law applicable to the years at issue here), "a [tax] deferral of unearned premium income [was permitted], while the expenses of earning the deferred income . . . [were] deducted currently."[7] See H. R. Rep. No. 426, 99th Cong., 1st Sess. 668-669 (1985); S. Rep.

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which remains outstanding today, directly supports Home's interpretation of the statute.

[7] To eliminate this "mismatching," Congress amended section 832(b)(4) by requiring property and casualty companies to include 20% of their unearned premiums in taxable income. The committee reports cited in the text explained that the inclusion of 20% of unearned premiums in income was designed to offset the current deduction for associated premium acquisition expenses. Premium acquisition expenses include commissions of the type involved here.

No. 313, 99th Cong., 2d Sess. 495-496 (1986); and General Explanation of the Tax Reform Act of 1986, Prepared by the Staff of the Joint Committee on Taxation 594-595 (May 1987). (Br. 8, 25-27; Rep. Br. 17) Home pointed out that if the Commissioner's position in this case were correct, then an amendment described by both Congressional tax-writing committees in 1985-1986 as an amendment "to provide a better matching of income and expenses" actually *created* widespread mismatching where none had existed before, by requiring the inclusion of 20% of the unearned premiums in taxable income before any of the associated unpaid commission expenses became deductible. (Br. 9)

The Commissioner contended that the reference to section 162 of the Code in section 832(c)(1) limits allowable deductions to those that fulfill both the "ordinary and necessary" and the "paid or incurred during the taxable year" requirements of section 162. (App. 8a, 23a-24a; Rep. Br. 4) The Commissioner further argued that since the commissions at issue did not meet the accrual tests of section 446(c)(2) and Treas. Reg. §1.461-1(a)(2), the commissions were not "incurred" within the meaning of sections 162 and 832(c)(1). (App. 8a, 22a) Finally, the Commissioner asserted, and Home acknowledged, that Home's method of accounting did not "clearly reflect income" within the meaning of section 446(b). (App. 8a, 22a)

Despite being challenged to do so (Br. 17-19; Rep. Br. 1, 3), the Commissioner never responded to Home's "dead letter" argument or suggested *any* role for section 832(b)(6) under his approach.

The Tax Court upheld the Commissioner's interpretation of section 832(c)(1), and in doing so, noted

that Home's position would result in the mismatching of income and expense. (App. 20a, 25a)

The court of appeals acknowledged (App. 6a-8a) the parties' competing statutory constructions of section 832(c)(1), but did not decide which construction of the statute was correct, or even respond to Home's "dead letter" argument regarding section 832(b)(6).[8] Instead, after first stating that the statute was "ambiguous" and "susceptible of more than one interpretation," the court disposed of the case by relying on the Commissioner's broad authority under section 446(b) of the Code to require taxpayers to use accounting methods that clearly reflect income. (App. 10a-12a and n.8) In upholding the Commissioner's disallowance of the claimed deductions, the court stated (App. 10a-11a):

> Where, as here, the Commissioner determines that a taxpayer's accounting methods do not clearly reflect income, . . . his determination is to be upheld unless "clearly unlawful". . . . In view of the ambiguity of the Code provisions in question, we cannot say that the Commissioner's disallowance of Home's deductions was "clearly unlawful". [footnote reference omitted]

The court acknowledged the existence of a line of cases holding that the Commissioner does not have authority under section 446(b) to reject a taxpayer's

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[8] With respect to Home's argument regarding the legislative history underlying the 1986 amendment to section 832(b)(4) of the Code (see pp. 7-8 and n.7, *supra*), the court of appeals stated that the argument was "not without some force," but concluded that the Congressional reports were simply "incorrect" in their description of then current law. (App. 8a-9a)

accounting method if that method is specifically authorized by other sections of the Code; however, the court concluded that those decisions were not applicable in this case because section 832 is "ambiguous with respect to application of the Statutory Method here and thus does not 'specifically authorize' its use for all tax accounting purposes." (App. 11a n.8)

REASONS FOR GRANTING THE PETITION

The court of appeals' decision to dispose of the case by relying on the Commissioner's authority under section 446(b) of the Code, without deciding the underlying statutory issue or responding to Home's "dead letter" argument, raises important issues of general application that warrant review by this Court.[9]

First, the failure of the court of appeals to respond in *any* fashion to an *uncontested* "dead letter" argument involving the obliteration of an entire 133-word subsection of the Code (along with related language in other subsections) conflicts with numerous decisions, including decisions of this Court, holding that the courts have a "duty" to interpret a statute, if possible, in a manner that will give meaning to all of its parts.

Secondly, the court of appeals improperly expanded the Commissioner's authority under section 446(b) of the Code by misapplying this Court's "clearly unlawful" standard for reviewing the Commissioner's ex-

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[9] The issues presented to this Court relate solely to the judicial responsibility of the courts to decide the underlying statutory issue presented in cases like this. Home does not seek review here of the underlying statutory issue itself, but rather an order directing the court of appeals to decide that issue on remand.

ercise of discretion under section 446(b). The only issue arising under section 446(b) in the cases establishing the "clearly unlawful" standard of review was whether the Commissioner had properly determined that the taxpayers' methods of accounting did not clearly reflect income, an issue *not* in dispute here. In this case, the court of appeals misapplied the "clearly unlawful" test by using it to impose on Home a virtually insurmountable burden of persuasion with respect to *questions of law* concerning the meaning of the underlying statutory provisions on which Home relied.

Finally, the decision below raises important questions regarding the allocation of responsibility among the branches of Government for enacting, interpreting, and enforcing the federal tax laws. Because the court of appeals sustained the Commissioner without deciding the statutory construction issues raised by Home, the court's decision is defensible only if the resolution of those issues makes no difference. But if the statutory construction arguments raised by Home are right, the court of appeals has permitted the Commissioner to use section 446(b) (i) to repeal one statutory provision by rendering it a "dead letter" (a function reserved exclusively for Congress), and (ii) to be the final arbiter of the meaning of another statutory provision (a function reserved exclusively for the courts).[10] Section 446(b) does not vest the

[10] The two statutory provisions involved in this particular case are section 832(b)(6) and section 832(c)(1). However, the implications of the court of appeals' decision extend far beyond this particular controversy, because the court has sanctioned the generalized use of section 446(b) in a way that permits the Commissioner to usurp the functions of both Congress and the courts, as discussed below.

Commissioner with the powers of all three branches of Government.[11]

A. The Court of Appeals' Failure to Respond in Any Way to Home's "Dead Letter" Argument Conflicts with Decisions of This Court.

This Court has consistently held that courts have a "*duty* 'to give effect, if possible, to every clause and word of a statute.'" (Emphasis added.) See *United States v. Menasche*, 348 U.S. 528, 538-539 (1955). This duty to construe a statute so as to give effect to all of its parts is a fundamental principle of statutory construction. See, *e.g.*, *Hoffman v. Connecticut Department of Income Maintenance*, 492 U.S. ___, 106 L.Ed.2d 76, 85 (1989); *United States v. Zacks*, 375 U.S. 59, 69 (1963);[12] *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307-308 (1961); *McDonald v. Thompson*, 305 U.S. 263, 266 (1938); *United States v. Hughey*, 877 F.2d 1256, 1260 (5th Cir. 1989); *Taylor v. General Motors Corp.*, 875 F.2d 816, 824 (11th Cir. 1989); *Witco Chemical Corp. v. United States*, 742

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[11] We note that the "dead letter" statutory construction argument advanced by Home in this case was not made to the courts in *Western Casualty & Surety Co. v. Commissioner*, 571 F.2d 514 (10th Cir. 1978), *aff'g* 65 T.C. 897 (1976), the only other case involving the same underlying statutory construction issue. Moreover, the courts did not dispose of that case under section 446(b) of the Code. Thus, the issues raised in this Petition were in no way involved in the *Western Casualty* case.

[12] In *Zacks*, this Court stated that this principle of statutory construction must yield if strict adherence to it would require the court to disregard clear indications of a contrary Congressional intent. In this case, there is no such indication of contrary Congressional intent. Indeed, the court of appeals acknowledged (App. 8a-9a) that the legislative history appears to *support* Home's construction of section 832(b)(6).

F.2d 615, 620 (Fed. Cir. 1984); *Pomper v. Thompson*, 836 F.2d 131, 133-134 (3d Cir. 1987); *Fowler Bros. & Cox, Inc. v. Commissioner*, 138 F.2d 774, 778 (6th Cir. 1943); *Woods v. Commissioner*, 91 T.C. 88, 98 (1988); Sutherland Statutory Construction (4th Ed.) ¶46.06 and cases cited therein.

The decision below conflicts with all of this precedent. The court of appeals explicitly acknowleged Home's "dead letter" argument as follows (App. 8a):

> Home argues that the phrase "expenses incurred" is a term of art that is defined for all [property and casualty] insurance tax purposes in § 832(b)(6) to mean "all expenses shown on the annual statement approved by [NAIC]" and that any other interpretation (e.g., that "expenses incurred" are only those "paid or incurred during the taxable year") renders § 832(b)(6) and related provisions a "dead letter".

Yet, nowhere in its opinion did the court consider the merits of Home's "dead letter" argument. Nothing in the opinion suggests *any* role whatsoever for section 832(b)(6) of the Code. Nor is there any suggestion in the court's opinion that there are unusual circumstances present here making it impossible to give effect to section 832(b)(6).[13]

Under the court of appeals' opinion and the Commissioner's position, we know of no conceivable case

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[13] To the contrary, by stating (App. 10a) that the statute is "susceptible of more than one interpretation," the court of appeals has acknowledged that Home's interpretation of the statute is "possible."

where the tax liability of a property and casualty insurance company (such as Home) would be changed by one cent if section 832(b)(6) of the Code were repealed. Under Home's construction of the statute, the repeal of section 832(b)(6) would make a decided difference in tax liability. The court of appeals had an obligation to decide whether Home's "dead letter" argument is correct, because if it is, sustaining the Commissioner's position in this case effectively permits him to repeal section 832(b)(6) administratively. This result is clearly an improper one; it is the exclusive province of Congress to repeal provisions of the Internal Revenue Code.

During the court of appeals proceedings, Home repeatedly challenged the Commissioner to respond to Home's "dead letter" argument by explaining the role that section 832(b)(6) of the Code would have under his construction of the statute. Home also challenged the Commissioner to explain, under his view of the statute, how Home's tax liability could ever change by even one cent if section 832(b)(6) and related language were completely excised from the statute. (Br. 17-18; Rep. Br. 1, 3) The Commissioner *never* responded to any of these challenges.

Thus, the court of appeals sustained the Commissioner's position in this case notwithstanding Home's *uncontested* assertion that the Commissioner was reading section 832(b)(6) out of the Code. The court's failure to respond to Home's *uncontested* "dead letter" argument is necessarily in direct conflict with the cases cited above, which hold that the courts have a duty to give effect, if possible, to all parts of a statutory provision.[14]

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[14] For purposes of this Court's review, it is immaterial whether

B. The Court of Appeals' Reliance on the Commissioner's Discretion Under Section 446(b) of the Code Without Deciding What the Applicable Substantive Statutory Provisions Mean Raises Important Questions Regarding (i) the Application of This Court's "Clearly Unlawful" Standard for Reviewing the Commissioner's Exercise of Discretion Under Section 446(b), and (ii) the Allocation of Governmental Responsibilities for Enacting, Interpreting, and Enforcing the Federal Tax Laws.

1. Introduction.

It is well settled that the Commissioner has broad discretion under section 446(b) of the Code to require that a taxpayer's method of accounting "clearly reflect income." Thus, this Court has stated that the Commissioner's "interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.' " See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979), quoting *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930). See also *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959). However, prior to the court of appeals' decision in this case, there has never been any suggestion that section 446(b) authorizes the Commissioner either to disregard a substantive provision of the tax law, or to dictate the interpretation of that provision, simply because (i) the provision is arguably "ambiguous" or "susceptible of more than one interpretation," and (ii) the taxpayer's interpretation does not

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Home's "dead letter" argument is, in fact, correct, and this Court need not decide that issue. The question presented here is whether the court of appeals had a judicial responsibility to respond to the uncontested "dead letter" argument, not whether that argument was correct.

clearly reflect income. (See App. 10a, 11a n.8; n.15, *infra*.)

To the contrary, it is well established that the Commissioner's admittedly broad discretion under section 446(b) does not permit him to reject an accounting method that is "specifically authorized" by the Code or the regulations, even though that accounting method may produce a mismatching of income and expense. See, *e.g.*, *Frysinger v. Commissioner*, 645 F.2d 523, 528 (5th Cir. 1981), *aff'g* 39 T.C.M. 1287 (1980) ("the Commissioner cannot use his discretionary authority to vitiate the benefits granted the taxpayer by his own regulations merely because the taxpayer's method may otherwise result in a distortion of income."); *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 31 (1988) ("Respondent's broad authority to determine whether a taxpayer's accounting method clearly reflects income is limited, in that he may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis."); *Orange & Rockland Utilities v. Commissioner*, 86 T.C. 199, 215 (1986) ("Since we have determined that the cycle meter reading method is a specifically permitted accrual method of accounting within section 446(c)(2), respondent's imposition of a condition of conformity was an abuse of discretion as respondent's discretion within section 1.446-1(c)(2)(ii), Income Tax Regs., is relevant only to determine whether a method of accounting not specifically permitted clearly reflects income."); *Auburn Packing Co. v. Commissioner*, 60 T.C. 794, 798 (1973) ("It is our view that the respondent cannot now prevail with the

argument that the method he approved in the regulation does not clearly reflect income."); *Cooper Communities, Inc. v. United States*, 678 F. Supp. 1408, 1414 (W. D. Ark. 1987) ("An accounting method that is explicitly authorized or prescribed by Congress cannot be rejected even if the Commissioner, on a sober evaluation of its impact, concludes that it does not clearly reflect income." (quoting Professor Bittker)); Bittker, *Federal Taxation of Income, Estates and Gifts*, Vol. 4, ¶105.1.6, pp. 105-118; Coplan, *Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion*, 83 Colum. L. Rev. 378, 397 (1983) ("The Commissioner's discretion [under section 446(b)] is also limited by specific statutory or regulatory authorizations of the accounting method challenged." (footnotes omitted)).

In short, the judiciary cannot grant the Commissioner discretion to disallow an accounting method that Congress has specifically allowed; any attempt on his part to do so would be "clearly unlawful" (*Lucas v. American Code Co., supra*, 280 U.S. at 449), because it would flout the will of Congress.

2. The Court of Appeals Misapplied the "Clearly Unlawful" Standard Established by This Court for Reviewing the Commissioner's Exercise of Discretion Under Section 446(b) of the Code.

The court below stated (App. 10a-11a):

> Where, as here, the Commissioner determines that a taxpayer's accounting methods do not clearly reflect income, Treas. Reg. § 1.446-1(a)(2), his determination is to be upheld unless "clearly unlawful". *RCA Corp. v. United States*, 664 F.2d 881, 886 (2 Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982); *see*

> *also Record Wide Distributors, Inc. v. Commissioner*, 682 F.2d 204, 206 (8 Cir. 1982) (taxpayer has a "heavy burden of proving that the Commissioner's determination is plainly arbitrary"), *cert. denied*, 459 U.S. 1171 (1983). Home concedes that its tax accounting method does not clearly reflect income and expense. In view of the ambiguity of the Code provisions in question, we cannot say that the Commissioner's disallowance of Home's deductions was "clearly unlawful". (footnote omitted)

Although the court referred only to the *RCA* and *Record Wide Distributors* cases, those cases, in turn, relied on the prior decisions of this Court cited above (p. 15, *supra*), which establish the "clearly unlawful" standard for reviewing the Commissioner's exercise of his discretion under section 446(b).

Neither *RCA*, *Record Wide Distributors*, nor the decisions of this Court support the decision below. All of those cases involved an entirely different issue. The only question arising under section 446(b) in those cases was whether the Commissioner exceeded his authority under that section of the Code by determining that the taxpayers' accounting methods did not clearly reflect income; the far different issue presented to the court of appeals in this case was whether Home's method of accounting was specifically authorized by the Code (in this case, sections 832(b)(6) and 832(c)(1)). Home agreed that its method of accounting did not clearly reflect income.

The court of appeals essentially held that if a taxpayer's interpretation of a statutory deduction provision is not "clearly right," then the Commissioner's

disallowance, under section 446(b), of a deduction taken pursuant to that statutory deduction provision will not be considered "clearly unlawful." This is the natural reading of the last sentence of the court's statement that is quoted above. The court relied on the "clearly unlawful" standard of review even though this case had nothing to do with the exercise of the Commissioner's discretion under section 446(b) to determine whether Home's method of accounting clearly reflected income (which was the *only* section 446(b) issue in the cases establishing the "clearly unlawful" standard of review). The court below interpreted this Court's "clearly unlawful" standard as somehow imposing on Home a heightened—and, for all practical purposes, insurmountable—burden of persuasion with respect to the underlying statutory construction issue.

Under the court of appeals' far-reaching view of section 446(b), the Commissioner *automatically* wins every case involving a Code provision that is "susceptible of more than one interpretation" once he determines that the taxpayer's interpretation of the provision does not result in a clear reflection of income.[15] Thus, the important tax-administration issue

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[15] It is unclear from the court's opinion whether the court concluded that (1) the Commissioner may disregard an ambiguous Code provision pursuant to his discretion under section 446(b) of the Code *even if* the taxpayer may be correct in its interpretation of that provision, or (2) the Commissioner's interpretation of an ambiguous Code provision will automatically be upheld if he determines that the taxpayer's interpretation of the statute does not result in a clear reflection of income. But the end result of either reading of the court's opinion is the same—*i.e.*, the Commissioner automatically prevails if (1) the statutory provision in question is "ambiguous" or "susceptible of more than one interpretation," and (2) the Commissioner determines

raised by the court of appeals' application of this Court's "clearly unlawful" standard of review is whether normal questions of law regarding the proper interpretation of operative income and deduction provisons of the Internal Revenue Code are to be resolved by the courts on a level playing field, or on a field sharply tilted in the Commissioner's favor, in cases where the taxpayer is contending that Congress has sanctioned a mismatching of income and expense.

Home believes that this Court's "clearly unlawful" test was not intended to alter the parties' normal burden of persuasion on *questions of law* regarding the meaning of operative provisions of the Code. Accordingly, this Court should grant certiorari "to consider whether the lower court misapprehended the scope of" this Court's prior opinions. See *Schlude v. Commissioner*, 372 U.S. 128, 130 (1963). See also *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 207 (1967); *Wilkinson v. United States*, 365 U.S. 399, 401 (1961).

3. The Determination Below Raises Important Questions as to the Proper Role of the Legislative, Executive, and Judicial Branches of Government in Federal Tax Matters.

In substance, the court below held that the Commissioner has the power under section 446(b) of the Code to require taxpayers to match income and expense in a fashion acceptable to the Commissioner in all cases in which the statutory provisions relied on by the taxpayer do not *unequivocally and incontestably* compel the result being sought by the taxpayer.

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that the taxpayer's interpretation of the statute does not clearly reflect income (App. 8a, 10a-11a and n.8).

Under the court's opinion, the Commissioner is effectively vested with the powers of all three branches of government; the taxpayer is denied a judicial determination as to the meaning of the Congressionally enacted provisions on which the taxpayer is relying if the Commissioner succeeds in casting any doubt on the meaning of those provisions and invokes section 446(b).

This unprecedented and far-reaching interpretation of the Commissioner's authority under section 446(b) cannot be correct. Over the years, Congress has enacted many substantive provisions that sanction mismatching of income and expense.[16] Certainly, the scope and reach of many of those provisions will not always be clear on their face. Congress surely expected that disputes regarding the interpretation and application of these statutory provisions ultimately would be decided by the courts, not unilaterally resolved by the Commissioner under section 446(b) of the Code.[17]

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[16] See, *e.g.*, the following provisions of the Internal Revenue Code of 1986: sections 168, 169, 184, 188, 194, 195(b)(1), and 248 (allowing accelerated methods of or shortened periods for depreciation); and sections 173, 174, 175, 179, 180, 193, 263(c), and 263(d) (allowing the deduction of amounts that would otherwise be chargeable to capital account).

[17] In numerous cases, the courts have resolved ambiguities in Internal Revenue Code provisions in favor of the taxpayer, even though the resulting interpretations produced results that did not "clearly reflect income." If the Commissioner were entitled to impose an accounting method that, in his view, "clearly reflects income" whenever there is any ambiguity in a statutory provision providing another method, these cases would have been decided differently. See, *e.g.*, *Snow v. Commissioner*, 416 U.S. 500 (1974) (ambiguity in section 174 resolved to permit the de-

The court of appeals' decision in this case therefore gives unreviewable discretion to the Commissioner by authorizing him to resolve all statutory ambiguities in his favor whenever the taxpayer's interpretation of the statute fails, in his view, to produce a proper matching of income and expense. The effect of the court's decision is to give the Commissioner carte-blanche authority to ignore, or dictate the interpretation of, Congressionally enacted laws in such cases.[18] The decision means that the existence of an ambiguity permits the Commissioner to reach the result he wants simply by invoking section 446(b).[19]

We submit that ambiguity in the governing statutory provisions does *not* permit the Commissioner to

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duction of research expenditures incurred to create an intangible asset with an indefinite useful life); *Laglia v. Commissioner*, 88 T.C. 894 (1987) (ambiguity in section 278(b) resolved to permit the deduction of jojoba planting and cultivating expenses that produced an asset with an extended useful life); *Estate of Straughn v. Commissioner*, 55 T.C. 21 (1970), *acq.*, 1976-2 C.B. 3 (ambiguity in section 175 resolved to permit the deduction of soil improvement expenditures incurred to increase the value of purchased farmland); *Triangle Publications, Inc. v. Commissioner*, 54 T.C. 138 (1970) (ambiguity in section 173 resolved to permit the deduction of payments made to acquire magazine customer lists having "no reasonably ascertainable useful life").

[18] See n.15, *supra*.

[19] The court of appeals purported to acknowledge that the Commissioner's discretion under section 446(b) of the Code may not be used to override a provision of the Code that "specifically authorizes" an accounting method, but the court stated that "[t]his exception [to the Commissioner's broad authority] is inapplicable here since § 832 is ambiguous with respect to application of the Statutory Method and thus does not 'specifically authorize' its use for all tax accounting purposes." (App. 11a n.8)

resolve all issues involving these provisions in his favor by invoking section 446(b). It is the responsibility of the courts, not the Commissioner, to resolve disputes between the Commissioner and taxpayers regarding the correct meaning of a law enacted by Congress; the Commissioner is empowered only to administer the law, not to make it. *Manhattan Co. v. Commissioner*, 297 U.S. 129, 134 (1936); *United States v. Calamaro*, 354 U.S. 351, 358-359 (1957).

To determine whether a statutory provision "specifically authorizes" a deduction in a case such as this where the parties have advanced different interpretations of the provision, the courts have an obligation to consider the competing statutory construction arguments and to determine whether the statute does or does not authorize the mismatching result that the taxpayer seeks. The court of appeals failed to do that in this case.

If Home's reading of sections 832(b)(6) and (c)(1) is correct, the statute *does* "specifically authorize" the claimed deductions,[20] thereby rendering section 446(b)

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[20] As stated at pp. 2-3, 6, *supra*, section 832(b)(6) provides that the expenses of a property and casualty company constitute "expenses incurred" for tax purposes in the year in which they are reflected on the NAIC annual statement, and Home reads section 832(c)(1) as allowing a deduction for all such "expenses incurred" that are "ordinary and necessary" as provided in section 162. The commissions involved here were *concededly* "expenses incurred" within the meaning of the quoted sentence of section 832(b)(6) and were *concededly* "ordinary and necessary" within the meaning of section 162(b). (App. 6a, 7a-8a; Br. 6, 11; Rep. Br. 13) We note that the treatment of a property and casualty company's expenses is in stark contrast to the rule applicable to life insurance companies, which are required to

inapplicable under the cases discussed at pp. 16-17, *supra*. Conversely, if the Commissioner's reading of the statute (see p. 8, *supra*) is right, there would be no need for him to resort to section 446(b), because the deductions claimed by Home would not be allowable under sections 832 and 162 as so interpreted. Section 446(b) is therefore a red herring in this case. The court of appeals could have and should have decided the case without reference to section 446(b) by determining whose construction of sections 832(b)(6) and 832(c)(1) was correct. As this Court stated in *White v. United States*, 305 U.S. 281, 292 (1938):

> It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be.

The fact that Home's reading of the statute produces a mismatching of income and expense provides no basis for denying Home its right to obtain a decision on the merits of its statutory construction argument. As this Court stated in *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955):

> [T]he rule that general equitable considerations do not control the measure of deduc-

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determine taxable income under an accrual method of accounting. See *Colonial American Life Insurance Co. v. Commissioner*, 491 U.S. ___, 105 L.Ed.2d 199 (1989); *Commissioner v. Standard Life & Acc. Ins. Co.*, 433 U.S. 148 (1977); and *Western Casualty & Surety Co. v. Commissioner*, 65 T.C. 897, 908 (1976), *aff'd*, 571 F.2d 514 (10th Cir. 1978).

> tions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. . . . [W]here the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.

Because Congress recognized the mismatching problem under the Code as in effect during the years at issue and took action in 1986 to resolve the problem prospectively (see pp. 7-8, *supra*), permitting the Commissioner to eliminate the mismatching for pre-1987 years through the exercise of his administrative discretion under section 446(b) is singularly inappropriate in this case. *Hanover Bank v. Commissioner*, 369 U.S. 672, 682-686 (1962). See also *Pink v. United States*, 105 F.2d 183 (2d Cir. 1939), involving the same statutory provisions that are involved here. Eliminating tax "loopholes" created by statute is the responsibility of Congress, not the Commissioner. As the Court stated in the *Hanover Bank* case, 369 U.S. at 682:

> The Government's primary reason for urging this interpretation of Section 125 is that the statute has created a tax loophole of major dimension that should be closed short of allowing the deduction sought in this case. While this assertion might have been persuasive in securing enactment of the amendments to the statute made subsequent to the time the transactions involved here took place . . . , it may not, of course, have any

> impact upon our interpretation of the statute under review. We are bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history.

This case dramatically illustrates the problems that arise when the Commissioner is allowed to invade Congressional and judicial territory. By allowing the Commissioner to use section 446(b) to eliminate mismatching retroactively for pre-1987 years, without deciding the statutory construction issues presented under section 832 of the Code, the court of appeals upheld a result that is inconsistent with the action taken by Congress in 1986 to cure the same mismatching problem prospectively. Under the court's decision, an amendment avowedly designed to *eliminate* existing mismatching in the *taxpayer's* favor was converted into an amendment that *created* future mismatching in the *Government's* favor. (See pp. 7-8, *supra*.) It seems self-evident that the Commissioner has infringed on Congress' responsibilities when the Commissioner's action cannot be squared with action taken by Congress to address the same issue.

The Commissioner's administrative response to this ongoing problem confirms that he has invaded Congressional territory. The Commissioner has stated (see Comm. Br. 33-34 n.18; Br. 16-21) that he will eliminate this future problem by *allowing* taxpayers who request relief to take the same commission expense deductions that he and the courts have *disallowed* in this case, even though there has been *no* change in *any* of the statutory provisions governing such deductions. Whether this discretionary, administrative response by the Commissioner will adequately respond to the future mismatching problem is uncertain, but also irrelevant

to the issues presented here. This situation aptly illustrates the dangers and consequences of permitting the Commissioner to use section 446(b) to ursurp legislative and judicial functions: the words of the governing statute mean what the Commissioner wants them to mean, and if he chooses, they can have different meanings on different days.

CONCLUSION

The petition for a writ of certiorari should be granted to determine whether the courts have a judicial responsibility to resolve statutory construction issues of the type squarely presented in this case.

Respectfully submitted,

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APPENDIX

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UNITED STATES COURT OF APPEALS,
SECOND CIRCUIT.

No. 901, Docket 88-4155.

The HOME GROUP, INC., as Agent Under the Provisions of Treasury Regulation Section 1.1502-77(d) for City Investing Company and the Consolidated Group of Which City Investing Company was the Common Parent,
Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

Argued March 23, 1989.

Decided May 11, 1989.

On appeal by a property and casualty insurer from a decision of the Tax Court which upheld a decision of the Commissioner of Internal Revenue disallowing deductions for unpaid future commission expenses attributable to deferred premium insurance policies, the Court of Appeals, Timbers, Circuit Judge, held that, since the Commissioner's determination that the insurer improperly deducted its commission expenses prior to the taxable year in which they were incurred was not "clearly unlawful", the decision of the Tax Court upholding the determination of tax deficiency should be affirmed.

Affirmed.

William L. Goldman, Washington, D.C. (George W. Beatty, Jane E. Wilson, and Lee, Toomey & Kent; Lester J. Mantell and Alan R. Sankin, New York City, on the brief) for appellant The Home Group, Inc.

Jonathan S. Cohen, Atty., Tax Div., Dept. of Justice, Washington, D.C. (James I.K. Knapp, Acting Asst. Atty. Gen., Gary R. Allen and Mary Frances Clark, Attys., on the brief) for appellee Commissioner of Internal Revenue.

Before OAKES, Chief Judge, TIMBERS and KEARSE, Circuit Judges.

TIMBERS, Circuit Judge:

Appellant The Home Group, Inc.[1] appeals from a decision entered August 24, 1988 in the United States Tax Court, Joel Gerber, *Judge*,[2] which determined deficiencies totalling $20,974,856 for the tax years 1968, 1969 and 1970 in the federal income taxes of the corporate taxpayer.

Home is a property and casualty insurer which issues through its agents insurance policies, the premiums on which are payable in installments ("deferred premium installment insurance policies"). Home's agents are entitled to commissions equal to a percentage of the premiums due on the policies sold. Premiums are paid by the policyholders to the agents who deduct their commissions and remit the balance to Home. Home uses the guidelines of the National Association of Insurance Commissioners[3] when

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[1] The Tax Court proceedings were initiated by City Investing Company (City), the former common parent of an affiliated group of corporations, including The Home Insurance Company and its wholly owned subsidiary The Home Indemnity Company (collectively "Home"). These three corporations filed consolidated federal income tax returns for the years here involved. City has since been liquidated. The Home Group, Inc., the current common parent of the affiliated group, has been substituted as appellant on this appeal.

[2] The Tax Court's original decision was entered January 15, 1987. 52 T.C.M. (CCH) 1422 (1987). An additional decision resolving the computation of the tax deficiencies was entered August 18, 1988. 91 T.C. 265 (1988). The final decision was entered August 24, 1988.

[3] References to the National Association of Insurance Commissioners include references to its predecessor, the National Convention of Insurance Commissioners.

filing annual statements of financial condition in calculating its taxable income. Home deducts the entire commission to be paid to its agents as a business expense in the year in which it issues a deferred premium installment insurance policy. It defers reporting premium income until it actually is "earned".

Upon audit of the federal income tax returns for 1968-70 filed by the parent of the affiliated group of which Home was then a member, appellee Commissioner of Internal Revenue (Commissioner) disallowed deductions for unpaid future commission expenses attributable to deferred premium installment insurance policies. The Tax Court upheld this determination, relying primarily on its decision in *Western Casualty & Surety Co. v. Commissioner*, 65 T.C. 897 (1976), *aff'd*, 571 F.2d 514 (10 Cir.1978). This appeal followed.

For the reasons which follow, we affirm.

I.

We summarize only those facts believed necessary to an understanding of the issues raised on appeal. The facts, most of which have been stipulated, are not in dispute.

Home is a property and casualty insurer. Through its independent insurance agents, it issues deferred premium installment insurance policies. Under these policies, a policyholder may pay premiums over a period of time rather than in a lump sum. Home's agents are entitled to commissions equal to a fixed percentage of the premiums due on the policies sold. Premiums are paid by the policyholders to the agents who deduct their commissions and remit the balances to Home. The deferred premium installment insurance policies may be cancelled prospectively by either the policyholder or Home. Nonpayment of premiums is not enough to cancel the policy. Until a policy is cancelled, Home remains responsible for losses covered by the policy and the policyholder remains obligated to pay the pre-

mium. If an insurance policy is cancelled, Home returns any portion of the premium it has received that is unearned on the cancellation date, less the agent's commission applicable to that portion of the premium. The agent then remits to the policyholder the full amount of the premium unearned on the cancellation date. The agent is not entitled to a commission based on any portion of the premium attributable to the period after cancellation.

Pursuant to state law, Home files annual statements of financial condition on National Association of Insurance Commissioners ("NAIC") approved forms (NAIC annual statements). These annual statements are prepared using the earned and incurred basis of accounting (known in the insurance industry and hereinafter referred to as the Statutory Method). Home also uses the Statutory Method in computing its taxable income. It deducts the entire commission to be paid to its agent as a current business expense in the year the deferred premium installment policy is issued (i.e., the year in which it is reported as an expense on the NAIC annual statement). It then reports its taxable income based on the premium actually "earned". The net tax effect of this procedure is to take a current deduction for unpaid expenses associated with a deferred premium which is not taken into income until later—effectively "mismatching" income and expense.

Upon audit of the consolidated federal income tax returns for the years 1968, 1969 and 1970 filed by the parent of the affiliated group of which Home was then a member,[4] the Commissioner disallowed the deductions claimed for unpaid commission expenses attributable to deferred premium installment insurance policies and issued a Notice of Deficiency dated April 15, 1982. The United States Tax Court, Joel Gerber, *Judge*, upheld the Commissioner's determination in a decision filed January 15, 1987 referred

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[4] *Supra* note 1.

to above. *See also supra* note 2. Relying principally on its prior decision in *Western Casualty, supra*, the Tax Court rejected Home's use of the Statutory Method of accounting for calculating its federal income taxes on the grounds that the method allows a deduction not normally allowed under established cash or accrual tax accounting procedures and that it fails accurately to reflect income and expenses. The Tax Court also rejected Home's alternative claim that the Statutory Method satisfies the traditional "all events" test for calculating deductible expenses on the ground that, although the amounts that may be paid as commissions were fixed, actual payment of such commissions nevertheless was contingent. On August 24, 1988, the Tax Court determined that Home owed income tax deficiencies for the years 1968-70 totalling $20,974,856. A timely notice of appeal was filed November 17, 1988.

On appeal, Home argues that the Tax Court erroneously construed the applicable provisions of the tax code in concluding that Home could not use the Statutory Method for calculating its deductible expenses; and that *Western Casualty*, upon which the court so heavily relied, was wrongly decided and should not be followed. Alternatively, Home argues that its deductions were proper even under traditional Code accrual accounting methods since it has satisfied the "all events" test for determining when an expense has become fixed, and thus, deductible.

The Commissioner argues that the court correctly relied on *Western Casualty* in holding that unpaid commissions are not deductible in the year the policy is issued; that a correct reading of the Code indicates that Home can deduct its expenses only in the taxable year during which they are incurred; and that the rejection of Home's tax accounting method on the ground that it did not accurately reflect income was not "clearly unlawful".

We have jurisdiction to hear this appeal pursuant to 26 U.S.C. § 7482 (1982). For the reasons stated below, we

affirm the Tax Court's determination of the tax deficiencies.

II.

With these facts and prior proceedings in mind, we turn next to the applicable law.

It is not disputed that the commissions paid by Home to its agents are deductible business expenses. Rather, the question is *when* they may be deducted—in the year the installment policies are issued (Home's position) or only when the deferred premium installments are paid and the commissions are taken by the agents (Commissioner's position). The question turns on the meaning of the Int.Rev.Code § 832(b)(6)[5] as modified by the cross-reference to § 832(c) and the further cross-reference from § 832(c)(1) to § 162.

Home is subject to the Code provisions specifically applicable to property and casualty insurance companies. § 831 *et seq.* Section 832(a) provides that the term "taxable income" is gross income as defined in § 832(b) less the deductions allowed by § 832(c). Section 832(b)(3) provides that the "underwriting income" component of gross income consists of the "premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred". Section 832(b)(6) defines "expenses incurred" as "all expenses shown on the annual statement approved by [NAIC]" and provides that the figure shall be computed as follows:

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[5] Unless otherwise stated, all statutory citations in the balance of this opinion are to sections of the Internal Revenue Code of 1954, as amended, which in turn correspond to the sections of Title 26 of the United States Code, 1982 codification.

For example, here, Int.Rev.Code of 1954, § 832(b)(6), 26 U.S.C. § 832(b)(6) (1982). We would cite it hereafter as § 832(b)(6).

> "To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c)."

Section 832(c)(1) provides in relevant part that

> "[i]n computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:
>
> (1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses). . . ."

Finally, § 162 allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year. . . ."

In rejecting Home's use of the Statutory Method to deduct commission expenses in taxable years before the commissions actually are paid, the Tax Court interpreted the reference in § 832(c)(1) to § 162 as governing not only *whether* an expense can be deducted (i.e., whether it is "ordinary and necessary") but also *when* the expense is deductible (i.e., only during the taxable year in which it is "paid or incurred"). The court held that generally applicable principles of accrual accounting are to be applied in determining whether an expense has been "paid or incurred" and that deduction of unpaid commissions in the year the policies are issued fails the "all events" test for determining when an expense has been "incurred".

Home argues that § 832(b)(6) determines *when* an expense falls into the category of deductible "expenses incurred" (i.e., when it is shown on the NAIC annual statement), while §§ 832(c) and 162(a) together merely determine *whether* the

expense incurred is deductible (i.e., whether it is "ordinary and necessary"). Home argues that the phrase "expenses incurred" is a term of art that is defined for all insurance tax purposes in § 832(b)(6) to mean "all expenses shown on the annual statement approved by [NAIC]" and that any other interpretation (e.g., that "expenses incurred" are only those "paid or incurred during the taxable year") renders § 832(b)(6) and related provisions a "dead letter". Home points to certain 1921 Congressional testimony to the effect that insurance companies are allowed use of an accounting method different from that applicable to other taxpayers and refers to steps taken by Congress in 1985 and 1986 to correct "mismatching" under the insurance tax provisions of the Code as evincing an implicit recognition by Congress that Home's method of computing its taxes (which it admits results in "mismatching") was allowable under the Int.Rev.Code of 1954.

The Commissioner argues that Home's reading of the Code effectively nullifies the requirement of § 162 that, for an expense to be deductible, it must be "paid or incurred during the taxable year". The Commissioner also argues that there is no support for Home's piecemeal reading of the Code and that Home's argument that § 832(b)(6) contemplates use of the Statutory Method as the exclusive method for insurance company tax accounting purposes is misplaced. The Commissioner further argues that the decision of the Tax Court should be affirmed because Home's use of the Statutory Method fails the "all events" test for determining when an expense has been "incurred" and because its determination that Home's accounting method did not "clearly reflect income" is not "clearly unlawful".

Home's argument based on the House and Senate reports accompanying the Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085, is not without some force. These reports indicate that the understanding of Congress in 1985 and 1986 of the meaning of § 832 was that it did not incorporate the timing requirements of § 162. S.Rep.

No. 313, 99th Cong., 2d Sess. 495-96 (1986)("Present law permits a deferral of unearned premium income, while the expenses of earning that deferred income (e.g., premium acquisition expenses) may be deducted currently".); H.R.Rep. No. 426, 99th Cong., 1st Sess. 668-69 (1985) (same). The Commissioner argues that these reports are just plain wrong. The only case addressing the issue of deductibility of commissions on deferred premium installment insurance policies, *Western Casualty, supra*, did not allow current deduction for unpaid commission expenses.[6] Accordingly, to the extent that the Congressional reports may be at odds with *Western Casualty*, we agree with the Commissioner that they are incorrect.[7]

Congress amended § 832 in 1986 to require recognition of more premium income in the year an insurance policy is issued in order, it explained, to offset the income "mismatching" allowed under that section. S.Rep. No. 313,

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[6] Indeed, *Western Casualty* was litigated and decided twice—once under the Int.Rev.Code of 1926, 44 Stat. 9, and once under the Int.Rev.Code of 1954. In both cases, the taxpayer sought to use the Statutory Method for tax purposes. In both cases the taxpayer was unsuccessful.

[7] We also decline to give effect here to these reports on the ground that deducing original legislative intent regarding the statutory provisions in question on the basis of actions taken by Congress years later is at best a hazardous undertaking. *Waterman S.S. Corp. v. United States*, 381 U.S. 252, 269 (1965). In *Pierce v. Underwood*, ___ U.S. ___, 108 S.Ct. 2541, 2551 (1988), the Supreme Court, in analyzing the meaning of the term "substantially justified" in the Equal Access to Justice Act, decided to ignore a House Report written in 1985 when the Act was reenacted. The Court held that the committee report did not provide an authoritative interpretation of the meaning of the original statute because "it is the function of the courts and not the Legislature, much less a Committee of one House of the Legislature, to say what an enacted statute means". *Id.* Since the House Report described judicial interpretations of the statute inaccurately, the Court also rejected the argument that the 1985 Congress intended to ratify the minority view of the law described by the report. We believe that this reasoning applies with equal force here.

supra, at 496; H.R.Rep. No. 426, *supra*, at 669. Relying on *Pink v. United States*, 105 F.2d 183 (2 Cir.1939), Home argues that closing a loophole by Congress indicates that the loophole must previously have existed. Home states that, as a result of the 1986 legislation, those insurers who always have followed the Commissioner's interpretation of the law have had to readjust their reporting so that a new mismatching is not created by the requirement of the amendment that more income be recognized. While this argument has a certain surface appeal, we believe that the events referred to do not require us to reverse the determination of the Commissioner and the Tax Court, especially where the provisions in question were susceptible of more than one interpretation.

[1] It appears that the intent of Congress in originally enacting the provisions of the Code relating to property and casualty insurance companies demonstrates only that the Statutory Method was to be used as the *starting point* for tax accounting. *Commissioner v. General Reinsurance Corp.*, 190 F.2d 148, 151 (2 Cir.), *cert. dismissed*, 342 U.S. 863 (1951). As stated in *Western Casualty, supra*, the Statutory Method thus is not absolute. *Western Casualty, supra*, 571 F.2d at 517; *see also General Reinsurance, supra*, 190 F.2d at 150-51 (statute prevails over Statutory Method where the two conflict); *cf. Gerling Int'l Ins. Co. v. Commissioner*, 839 F.2d 131, 134 n.6 (3 Cir. 1988) (§ 162 prevents an insurance company from deducting "expenses not yet actually paid or incurred"). An accounting practice for bookkeeping purposes is not necessarily what the Code allows for tax accounting purposes. *United States v. Hughes Properties, Inc.*, 476 U.S. 593, 603 (1986); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 541-44 (1979).

[2, 3] Under § 446(b), taxable income is to be computed under the accounting method regularly used by the taxpayer for keeping his books unless the method used "does not clearly reflect income". *Thor Power Tool, supra*, 439 U.S. at 531-32. Where, as here, the Commissioner deter-

mines that a taxpayer's accounting methods do not clearly reflect income, Treas.Reg. § 1.446-1(a)(2), his determination is to be upheld unless "clearly unlawful". *RCA Corp. v.. United States*, 664 F.2d 881, 886 (2 Cir.1981), *cert. denied*, 457 U.S. 1133 (1982); *see also Record Wide Distributors, Inc. v. Commissioner*, 682 F.2d 204, 206 (8 Cir.1982) (taxpayer has a "heavy burden of proving that the Commissioner's determination is plainly arbitrary"), *cert. denied*, 459 U.S. 1171 (1983). Home concedes that its tax accounting method does not clearly reflect income and expense. In view of the ambiguity of the Code provisions in question, we cannot say that the Commissioner's disallowance of Home's deductions was "clearly unlawful".[8]

We decline Home's invitation to hold that the Commissioner's disallowance of Home's deductions was "clearly unlawful."[9]

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[8] Home argues that, while the Commissioner has broad authority to reject an accounting method, he cannot reject a taxpayer's accounting method which is "specifically authorized in the Code or regulations and has been applied on a consistent basis". *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 31 (1988) (citing *Orange & Rockland Utilities, Inc. v. Commissioner*, 86 T.C. 199, 215 (1986)). This exception is inapplicable here since § 832 is ambiguous with respect to application of the Statutory Method here and thus does not "specifically authorize" its use for all tax accounting purposes.

[9] Home argues in the alternative that its deductions pass muster since, at the time its policies were issued, "all events" necessary to fix the amount of the premiums to be collected and commissions to be paid had taken place. The "all events" test requires that, in order for an expense to be deductible, all events necessary to establish the fact of liability must have occurred and the amount of the deduction must be capable of being estimated with "reasonable accuracy". *Hughes Properties, supra*, 476 U.S. at 600. Treas.Reg. § 1.446-1(c)(1)(ii); Treas.Reg. § 1.461-1(a)(2). Liability must be "firmly established" before the deduction may be taken. *United States v. General Dynamics Corp.*, 481 U.S. 239, 243 (1987).

We disagree with Home's assertion that the "all events" test is

III.

To summarize:

Since the Commissioner's determination that Home improperly deducted its commission expenses prior to the taxable year in which they were incurred was not "clearly unlawful", the decision of the Tax Court upholding the determination of tax deficiencies is affirmed.[10]

Affirmed.

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satisfied since, at the time the policies were issued, the amount of commissions actually paid to the agents remained contingent on the policyholder (or Home) not cancelling the policy—an event which is not unlikely to occur. *Brown v. Helvering*, 291 U.S. 193, 200-01 (1934). We believe that this result is not inconsistent with *Hughes Properties, supra*, where a deduction for progressive slot machine jackpots was allowed in the tax year before the jackpot actually was won, since there the expense was virtually certain to be paid eventually whereas here Home's liability for commission expenses remained contingent on payment of the premiums by the insureds to the agents—an event which cannot be considered a "mere technicality". *General Dynamics, supra*, 481 U.S. at 244.

[10] We express no opinion on the proper method of reporting by Home or any other insurer subject to § 831 *et seq.* of income and expense for federal income tax purposes for years other than those specifically here involved.

UNITED STATES TAX COURT

City Investing Company v. Commissioner.

Docket No. 17739-82. T.C. Memo 1987-36. Filed January 15, 1987.

John S. Breckinridge, Jr. and F. Brook Voght, for the petitioner. David N. Brodsky and Robert J. Foley, for the respondent.

Memorandum Findings of Fact and Opinion

GERBER, Judge: Respondent determined deficiencies in petitioner's Federal income tax for taxable years 1968, 1969 and 1970 as follows:

Year	*Deficiency*
1968	$ 208,673
1969	19,789,652
1970	1,406,012

After concessions, the issue presented is whether unpaid commissions to insurance sales agents on deferred premium installment payments are deductible in the year the policy is issued pursuant to section 832(b)(6).[1]

Findings of Fact

Some of the facts have been stipulated. The stipulation of facts and supplemental stipulation of facts are incorporated herein by this reference.

Petitioner, the common parent of an affiliated group of corporations including Home Insurance Company (Home) and the Home Indemnity Company (Indemnity), timely filed 1968, 1969 and 1970 Federal income tax returns with the Internal Revenue Service at New York. Home and Indemnity[2] were both incorporated under the laws of the

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

[2] Home and Indemnity were members of the affiliated group for which the consolidated returns were file. Reference to Home includes reference to Indemnity unless otherwise noted.

State of New York and commenced insurance business in 1853 and 1930, respectively. New York was petitioner's principal place of business at the time the petition herein was filed. Home was nationally engaged in the property and casualty insurance business.[3] As required by the states in which it was licensed, Home annually filed a statement of financial condition (annual statement) on forms approved by the National Association of Insurance Commissioners (NAIC).[4] Home completed the annual statements in accordance with the instructions issued by the NAIC, which required the use of the "accrual," i.e., "earned and incurred basis" as the method of accounting (NAIC statutory method).[5] Home also followed the NAIC statutory method of accounting in computing its separate taxable income included in petitioner's consolidated tax returns.

During the years at issue, Home sold insurance policies covering varying lengths of time. The policies were issued on preprinted forms that Home provided its agents. With respect to policies with terms of three years or less, Home sometimes allowed the insured the option of paying all the premiums at the inception date of the policy or paying in

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[3] For Federal income tax purposes, Home was a property and casualty insurer and subject to the provisions of subchapter L, part 3, secs. 831 et seq.

[4] Reference to the NAIC includes reference to its predecessor, the National Convention of Insurance Commissioners.

[5] Since before 1921, the NAIC has required insurance companies, such as Home, to use the so called "statutory method" for completion of the annual statement. Under this method, as provided in the NAIC annual statement instructions, insurance companies may account for policies having a term of more than one year in one of two ways. The company may elect to record the annual installment as a premium written in the calendar year it becomes due or in the calendar year the policy was issued, as if the entire policy were prepaid. All commissions attributable to amounts included as premiums written must be recorded as paid expenses for the year of inclusion. The instructions also provide that policies having a term of one year or less are to be treated as if the premiums are prepaid.

installments.[6] Home could complete the policy form such that the insured: Was required to pay the total premium due on the inception date; was required to pay in installments; or was given an option to pay the total premium on the inception date of the policy or in installments. Given the option, some insureds chose to pay the premium in a single payment and others elected installment payments.

During the years at issue, Home sold policies mainly through the American Agency System, representing about 7,500 licensed independent insurance agents. The agents received commissions (specified percentages of premiums written) on policies they issued on Home's behalf as compensation.[7] All premium payments by the insured were to be made to the agent, not Home, regardless of the method of payment.[8] After the agent received the premium from the insured, commissions were deducted and the balance remitted to Home.

In the event an insurance policy was canceled,[9] Home returned to the agent any portion of the premium it re-

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[6] If the insured chose the latter, the total payment sometimes included a handling charge.

[7] The actual percentage varied depending on the type of coverage.

[8] The agreement between Home and its agents imposed a duty of collection of premiums on the agents with a remittance time limit of 60 days after the recording of the premium on Home's books. If Home collected the premiums from the insured, the agent received no commission.

[9] The insurance policy could be canceled prospectively by either the insured or Home. The insured could cancel the policy at any time by giving Home notice and returning the policy or a lost policy form. Mere nonpayment of premiums was not enough to cancel the policy. Normally, the insured notified the agent and returned the policy. If the insured canceled the policy, Home computed the earned premium using the short-rate table. Home was required to refund any excess of paid premium above the customary short-rate for the expired time. The short-rate included a penalty, inversely related to the length of time

ceived that was unearned on the cancellation date, less the agent's commission applicable to that portion of the premium. The agent was required to remit to the insured the full amount of the premium unearned on the cancellation date. The agent was not entitled to a commission pertaining to any portion of the premiums attributable to the period following the date of cancellation.

Regardless of the method of payment the insured selected, Home's accounting entries never varied: on the date the policy was issued, Home recorded in the premiums-written account the total amount of premiums due and in the expenses-incurred account the total amount of commissions to be earned.[10] Thus, Home's premiums-written account consisted of the total premiums shown in each insurance policy issued during the taxable year, even if the total premium was not due in such year.[11] Federal

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unexpired on the policy.

Home could cancel the policy at any time by giving the insured a five or ten days' written notice of cancellation. One circumstance under which Home generally would cancel a policy was nonpayment. If Home chose to cancel the policy, the cancellation was pro rata. In the event of cancellation, Home was required to tender the excess of premium paid above the pro rata premium for the expired time on demand, unless Home had already tendered that amount with the written notice of cancellation.

Home remained responsible for losses covered by the insurance policy, and the insured obligated to pay the premium, until the policy was canceled.

[10] The expenses-incurred account consisted of other expenses (like unpaid loss adjustment expenses) besides commission expenses.

[11] For NAIC purposes, deferred premium installments may be included in the premiums-written account, and Home so elected. The NAIC instructions require that all commissions associated with premiums included in the premiums-written account be expensed currently.

Including deferred premium installments in the premiums-written account had economic consequences to Home, apart from those associated with Federal income tax (and indirect Federal income tax con-

taxable income, however, is based on premiums earned rather than premiums written. Thus, deferred premium installments were not included in income for Federal income tax purposes. Additionally, and consistent with the NAIC annual statement instructions, all commissions applicable to premiums recorded in the annual statement as premiums written were recorded as paid expenses.[12] The Federal tax effect of the NAIC sanctioned accounting procedures, therefore, would be to allow current deduction for expenses associated with deferred premiums which are not taken into income until earned. This method of accounting for premiums written was adopted by Home prior to 1951 and was commonly used in the property and casualty industry for completion of the annual statement.

Also consistent with the NAIC statutory method of accounting, Home recorded premiums written but uncollected at the taxable year end, including deferred premium installments less the commissions applicable thereto, in an asset account in the annual statement (agents' balances and uncollected premiums).

The commissions applicable to deferred premium installments for the taxable years in issue are as follows:

Year	*Home*	*Indemnity*
1968	$35,091,343.08	$3,899,038.12
1969	37,402,575.33	4,155,841.70
1970	35,623,957.85	3,958,217.54

Opinion

We are asked to decide whether petitioner may currently deduct unpaid commission expenses attributable to

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sequences through state and local tax deductions); for example, Home's state and local taxes and franchise fees were based on premiums written.

[12] Accordingly, no reserve or liability account for commissions with respect to deferred premium installments was contained in the annual statement.

premium installments not yet due. Property and casualty insurers, such as petitioner, are taxed under section 831 et seq. These provisions are detailed, and codify some tax principles based upon established practices in the property and casualty insurance industry.[13] These provisions were specially enacted for the insurance industry and include some tax accounting principles not permitted in computing the tax liability of other businesses.[14] See *Bituminous Casualty Corp. v. Commissioner* [Dec. 31,031], 57 T.C. 58, 80 (1971).

Section 831 contains the general rule that corporate tax rates as set forth in section 11 are imposed on certain insurance companies such as Home. Section 832(a) defines taxable income for such companies, and section 832(b), as pertinent herein, defines gross income, underwriting income, premiums earned and expenses incurred. Section 832(c) states which deductions are allowed.[15]

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[13] Subchapter L of the Internal Revenue Code of 1954 covers the income taxation of insurance companies. Secs. 801 through 826 cover specific life, mutual and certain other specifically enumerated types of insurance companies. Secs. 831 and 832 apply to all other insurance companies, including property and casualty insurers.

[14] The issue under consideration (the timing of the deductibility of commissions attributable to deferred premium installments), however, is not unique to the property and casualty insurance industry. Although the insurance industry may be distinguished from other businesses (because premiums from the sale of insurance policies come first and the major costs and losses come later) the issue at hand does not result from this unique aspect of the insurance industry.

[15] Taxable income is defined as "the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c)." Gross income, as defined in sec. 832(b)(1) includes, inter alia, the combined gross amount earned from investment income and underwriting income computed on the basis of the underwriting and investment exhibit of the annual statement and gain from the sale or other disposition of property. Underwriting income is defined as follows: "the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred." "Premiums earned" is computed as

Section 832(b)(6) provides that "expenses incurred" means "all expenses shown on the annual statement approved by the National [Association] of Insurance Commissioners," and provides that the term shall be computed as follows:

> To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

Section 832(c) provides that "[i]n computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions: (1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses) * * *."

The controversy centers on the parties' interpretations of sections 832(b)(6) and 832(c), and whether those sections in conjunction with section 162 or the NAIC statutory method of accounting control the timing of deducting commission expenses associated with deferred premium installments not yet paid.[16]

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follows: "From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance * * *, add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year."

[16] Secs. 831 et seq. incorporate accrual-type accounting concepts, and the NAIC instructions require the use of the "accrual, *i.e.*, earned and incurred basis" as the method of accounting, for completion of the annual statement. With respect to the specific item at issue, however,

We have considered this same issue in *Western Casualty & Surety Co. v. Commissioner* [Dec. 33,642], 65 T.C. 897 (1976), *affd.* [78-1 USTC ¶ 9220] 571 F.2d 514 (10th Cir. 1978).[17] Petitioner here, as the taxpayer in *Western Casualty*, seeks to currently deduct such expenses under the NAIC statutory method and argues that this case is factually distinguishable from *Western Casualty*.[18] Petitioner, in the alternative, contends that the transactions meet the "all events test." Respondent contends that *Western Casualty* governs, that in this instance use of the NAIC statutory method does not result in a clear reflection of income and that petitioner is not entitled to the deduction for its failure to meet the "all events test." We agree with respondent.

This case is factually similar to *Western Casualty* in which a property and casualty insurance company, like Home, issued multi-year insurance policies and chose to include all deferred premium installments as premiums written in the year of issuance. Western Casualty, in accordance with NAIC instructions, currently deducted as expenses all commissions attributable to those premiums.

In *Western Casualty* we disallowed the deduction.[19] We determined that Western Casualty was an accrual basis

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the NAIC annual statement unconditionally allows deductibility whereas, in this case, application of secs. 832(b)(6), 832(c) and 162 and traditional cash and accrual accounting concepts may not.

[17] All subsequent references to our opinion in the noted case will be made to *Western Casualty*.

[18] Petitioner here, however, does not argue that the annual statement required by the NAIC governs for Federal income tax purposes. Rather, petitioner contends that the NAIC's statutory method of accounting is a proper method of accounting for tax purposes. Petitioner concludes that the statutory method controls the timing of deductions, thus permitting the deduction in question.

[19] Actually, *Western Casualty* has been litigated and decided two times, once under the Revenue Act of 1926, 44 Stat. 9, and once under the

taxpayer and we found that the all events test, as set forth in section 1.461-1(a)(2), Income Tax Regs., was not satisfied.[20] We found that Western Casualty was not liable to its agents for such commissions until the insured actually paid the agent the premium installment. We also reasoned that a current deduction for commissions attributable to deferred premium installments would result in a mismatching with related income items and distortion of income.[21]

Petitioner contends that *Western Casualty* is distinguishable in three ways: (1) The policies in *Western Casualty* lapsed on mere nonpayment whereas the policies here continue until notice of cancellation is given; (2) Western Casualty maintained a reserve account (a liability account) for unearned premiums whereas none is maintained here; and (3) Western Casualty stipulated that it was an accrual method taxpayer, whereas Home maintains that it uses the "NAIC statutory method of accounting." We find petitioner's distinctions to be without a difference and we are not inclined to overrule our holding in *Western Casualty*.

Petitioner's distinctions go to the type of accounting method Home uses and the rules applicable thereunder.

1954 Code. In both instances, the taxpayer sought to employ their statutory reporting method for tax purposes and in both instances the taxpayers were unsuccessful.

[20] The regulation, in pertinent part, provides:

Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. * * * [T]he fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

[21] The mismatching of income results from taxable income being based on premiums earned and the annual statement being based on premiums written.

Petitioner fervently argues that it follows the "NAIC statutory method of accounting," and contends that the deduction at issue is allowable for Federal income tax purposes because it is a permissible method in completing the annual statement. Petitioner seeks to have the "NAIC statutory method of accounting" recognized as a controlling, separate alternative accounting method, a method which is not always in harmony with traditional cash or accrual tax accounting concepts.[22] Petitioner concludes that the "NAIC statutory method of accounting" should be used to determine the taxable year in which deductions are to be allowed. Respondent argues that the commissions are not deductible currently because they have not yet been paid or incurred. Additionally, respondent contends that allowing the commissions to be expensed currently results in a mismatching of income and expense.

We hold that for Federal income tax purposes, property and casualty insurance companies such as Home are governed by sections 831 et seq. and where the NAIC statutory method differs from sections 831 et seq., the latter must govern if a clear reflection of income does not result from the application of the NAIC statutory method.[23] We reach this conclusion after carefully considering both the Internal Revenue Code's statutory scheme (sections 831 et seq.) and the NAIC statutory method.[24]

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[22] As discussed later, petitioner alternatively argues that the expenses in question would also be allowable under an accrual method.

[23] Our decision here also comports with *Commissioner v. Standard Life & Accident Insurance Co.* [77-2 USTC ¶ 9480], 433 U.S. 148 (1977). The issue decided in that case involved the extent that deferred and uncollected life insurance premiums were includable in reserves, assets, and gross premium income, as those concepts were used in the Life Insurance Company Income Tax Act of 1959.

[24] Petitioner relies on Rev. Rul. 55-580, 1955-2 C.B. 282, for the proposition that the NAIC statutory method of accounting determines the timing for the deductions at issue. We disagree. Rev. Rul. 55-580 allowed current deductions for unpaid loss adjustment expenses (sec.

In order to hold for petitioner, we would have to find that in this instance, application of the NAIC statutory method results in a clear reflection of income. This we cannot do.

Sections 832(b)(6) and 832(c) include the requirement that an expense must be "incurred" before it is deductible. (Petitioner refers to this as a "timing requirement.") The NAIC statutory method of accounting is basically an accrual method. Generally, sections 831 et seq. employ accrual accounting principles. Petitioner contends that the NAIC statutory method permits the deduction in question and that it is a method of accounting separate and apart from the cash and accrual methods of accounting used for tax purposes. Respondent argues that petitioner is on an accrual method as dictated by sections 831 et seq. in conjunction with section 162 and Internal Revenue Code sections outside of subchapter L. We hold that petitioner is on an accrual method of accounting, as modified by the requirements of sections 831 et seq.

A major disagreement of the parties concerns whether the timing, as opposed to the deductibility, is to be determined under the NAIC statutory method or the tax accounting principles established outside of subchapter L. Both parties argue at length about whether section 162 (referenced in section 832(c)(1)) applies to limit expenses otherwise deductible under section 832(b)(6), as to their timing and type or as to type alone. Section 162(a), in

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832(b)(5)(B) allows a deduction for unpaid losses). Rev. Rul. 55-580 does not apply to these facts. Unpaid losses are unique to the insurance industry; agents commissions are not. Accordingly, the rationale for allowing unpaid loss estimates (and the expenses associated therewith as well) to be currently deductible does not necessarily apply to allow the deductibility of the expenses at issue now. We also note that Rev. Rul. 70-552, 1970-2 C.B. 141, includes the position that sec. 832, in effect, places casualty insurance companies on an accrual method of accounting with respect to income and deductions, thus allowing expenses to be deductible in the year that they fulfill the all events test.

pertinent part, limits allowable deductions to those that are "ordinary and necessary" and "paid or incurred during the taxable year." Petitioner argues that the reference to section 162 applies to the type of deduction allowable, not to the timing of the deduction. Respondent construes section 832(c) as limiting the deductions allowable to those that fulfill all requirements of section 162: deductions that are "ordinary and necessary" and that are "paid or incurred during the taxable year." Section 7701(a)(25) indicates that "paid or incurred * * * shall be construed *according to the method of accounting upon the basis of which the taxable income is computed under subtitle A.*" (Emphasis added.) Yet, section 832(b)(6) also contains a separate "incurred" limitation. Under these circumstances and relying heavily upon our holding in *Western Casualty*, we find that petitioner must meet the timing requirements on this deduction in the same manner as any other taxpayer under an accrual method of tax accounting. It seems clear that Congress did not intend that this deduction, which is not unique to the insurance industry or separately provided for in subchapter L, to be treated differently from other taxpayers subject to the Internal Revenue Code.

Approval of the NAIC statutory method under these circumstances would result in allowing a deduction for Federal income tax purposes that would not normally be allowed under established cash or accrual tax accounting principles. Only on the rarest occasions are taxpayers allowed to deviate from established cash and accrual accounting concepts in computing taxable income, and then only if the method of accounting used clearly reflects income. See *Bay State Gas Co. v. Commissioner* [82-2 USTC ¶ 9582], 689 F.2d 1 (1st Cir. 1982), affg. [Dec. 37,501] 75 T.C. 410 (1980). A deviation from the established methods of tax accounting is not warranted in this case.[25]

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[25] A taxpayer's method of accounting is a permitted method if it comports with generally accepted accounting principles, is consistently

In reaching our conclusion we considered several factors. First, to hold otherwise would result in a lack of symmetry and resultant mismatching of income and expense. See *Commissioner v. Standard Life* [77-2 USTC ¶ 9480], 433 U.S. 148 (1977). Petitioner points to no reason why the deduction should be allowable besides the fact that the NAIC instructions provide for it and the accounting procedures are common to the industry. Moreover, the expenses in question are not unique to the insurance industry. Secondly, petitioner seems to fault the statutory scheme only when it has an adverse effect upon its tax liability.

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used by the taxpayer from year to year, and is consistent with the regulations. Sec. 1.446-1(c)(1)(ii), Income Tax Regs.; *Public Service Co. of New Hampshire v. Commissioner* [Dec. 38,865], 78 T.C. 445 (1982). Sec. 446(a) generally provides that a taxpayer shall compute income by the method of accounting and basis by which the taxpayer regularly keeps the books. Subsection (c) provides that a taxpayer may compute its taxable income under any of the following methods: Cash receipts and disbursements, an accrual method, any other method permitted by subchapter E (secs. 441 through 483), or any of the foregoing methods permitted under the regulations. Subsection (b) allows the Commissioner to recompute a taxpayer's income if the taxpayer's method does not clearly reflect income. The Commissioner has wide discretion in determining whether a particular method of accounting should be disallowed as not clearly reflecting income. *Thor Power Tool Co. v. Commissioner* [79-1 USTC ¶ 9139], 439 U.S. 522, 521 (1979).

Petitioner contends that the accounting procedures it uses are commonly used in the industry, and that it has consistently followed them. These are factors to be considered, but they are not determinative. *Public Service Co. of New Hampshire v. Commissioner, supra* at 455; see also *Coors v. Commissioner* [Dec. 32,003], 60 T.C. 368, 395 (1973) ("[a] failure to clearly reflect income over many years cannot be justified on the grounds of tenure"). Another factor to be considered in determining whether an accounting method clearly reflects income is whether that accounting method conforms to generally accepted accounting principles. See sec. 1.446-1(a)(2), Income Tax Regs.; *Public Service Co. of New Hampshire v. Commissioner, supra* at 455. During the years at issue, the American Institute of Certified Public Accountants required a financial statement footnote reflecting that acquisition expenses (including commissions paid to agents) had been charged as paid (instead of accrued over the life of the policy contract).

Petitioner is not heard to complain that its taxable income is based on premiums earned rather than premiums written; instead, it chooses to question only one side of the equation. This we cannot condone.[26]

Respondent has adjusted petitioner's income with respect to commissions attributable to deferred premium installments not yet due. Respondent disallowed the deduction as not properly accruable until the commissions are actually paid.

Petitioner, in the event that we did not find the NAIC statutory method to be controlling, contends in the alternative that the liabilities in question are fixed. Petitioner specifically contends that the policies in *Western Casualty* lapsed upon nonpayment whereas the policies here continue until notice of cancellation is given, and that Western Casualty maintained a reserve account whereas none is maintained here. We do not find these distinctions to be persuasive.

Petitioner challenges respondent's disallowance as inconsistent with accrual accounting concepts, and complains that: (1) Respondent has raised no issue relating to petitioner's method for recording premium income as premiums written or deduction of commissions recorded as paid applicable to premiums required or elected to be paid in a single payment due on the inception date of the insurance policy (including commissions related to premiums due but uncollected by the end of the taxable year on policies issued during the taxable year and providing for periods up to three years); (2) the proposed adjustment would require the creation of a hypo-

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[26] Although not applicable here, the Tax Reform Act of 1986 would increase property and casualty insurance company income by 20 percent of the annual increase in unearned premiums. Also, 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before Jan. 1, 1987, is included ratably over a six-year period commencing with the first taxable year beginning after Dec. 31, 1986. See H. Rept. 99-841, Vol. II, pp. 11-355 (1986).

thetical account on petitioner's books for commissions on deferred premium installments; and (3) respondent's position is incongruous because petitioner would have to report more income the first year if it received the first installment payment rather than the entire amount due.

Respondent's proposed changes are consistent with accrual accounting principles. Commissions attributable to deferred premium installments not yet due should be disallowed as deductions if all of the events permitting accrual have not occurred during the taxable year in issue. Whether commissions attributable to prepaid multi-year policies are deductible currently, is not an issue in this case and we express no opinion on those deductions. Petitioner's "bookkeeping" argument does not address the issue and presents an equitable consideration which we find unpersuasive. Finally, petitioner's point regarding how much income it must report if it received the first installment payment rather than the entire amount due is also not at issue.

Before an expense may be accrued under accrual accounting principles, all of the events must have occurred which establish the fact of liability and the amount must be capable of being determined with reasonable accuracy. Sec. 1.461-1(a)(2), Income Tax Regs.[27]

It is well settled that a liability does not accrue as long as it remains contingent. *United States v. Hughes Properties, Inc.* [86-1 USTC ¶ 9440], ___ U.S. ___ (June 3, 1986); *Brown v. Helvering* [4 USTC ¶ 1223], 291 U.S. 193, 200 (1934). A liability must be "final" (*Security Flour Mills Co. v. Commissioner* [44-1 USTC ¶ 9219], 321 U.S. 281, 287 (1944)), "fixed and absolute" (*Brown v. Helvering, supra* at 201), and "unconditional" (*Lucas v. North Texas Lumber Co.* [2 USTC ¶ 484], 281 U.S. 11, 13 (1930)).

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[27] See also *United States v. Anderson* [1 USTC ¶ 155], 269 U.S. 422, 441 (1926), where the all events test was first enunciated.

As previously stated, the deductions in *Western Casualty* were disallowed because we found that the expenses failed the all events test. There we stressed that under the contract terms the insured was under no obligation to pay future installments. The insured's failure to pay premium installments as they became due resulted in cancellation of the policy. Thus, we found that the liability was not fixed.

Petitioner alleges that the insured's liability for payment of premiums was fixed at the date of inception, subject only to the risk of nonpayment, and cites to a number of cases for the proposition that the risk of nonpayment by a purchaser does not defeat the current accrual of commissions on sales.[28] As we stated in *Western Casualty*, those cases, unlike the present case, concern taxpayers obligated to make future installment payments. The cases stand for the principle that a taxpayer's accrual of related commission expense deductions will not be disallowed simply because the commissions may never be paid due to the risk of collection. See *Western Casualty*, 65 T.C. at 904.

According to the contract terms here, the insured could prospectively cancel the agreement at any time. Should this occur, although Home charged the insured at a higher rate for the lapsed time period, the agents received no commissions pertaining to the period beyond the cancellation date.[29] This does not amount to a liability "fixed and absolute," "final," and "unconditional." Although the

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[28] See, e.g., *W.S. Badcock Corp. v. Commissioner* [74-1 USTC ¶ 9319], 491 F.2d 1226 (5th Cir. 1974); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952), cert. denied 344 U.S. 874 (1952); *Ohmer Register Co. v. Commissioner* [42-2 USTC ¶ 9777], 131 F.2d 682 (6th Cir. 1942).

[29] Additionally, we note that Home itself could cancel an insured's policy simply by giving notice. It seems anomalous to allow Home to accrue a deduction when the expense in question later can be avoided entirely at Home's election.

amount that may be paid as commissions is fixed in amount, it is still contingent.[30]

Finally, although petitioner states that it does not maintain a reserve account and the taxpayer in *Western Casualty* did, we fail to see how that factor should make a difference in this case.

Due to concessions by the parties,

Decision will be entered under Rule 155.

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[30] Petitioner, in its reply brief, argues that the liability in question was fixed, and that cancellation of the policy is a condition subsequent to the fact of liability. Petitioner cites several cases in support of its proposition, including *Ohio River Collieries Co. v. Commissioner* [Dec. 38,700], 77 T.C. 1369 (1981); *Buckeye International, Inc. v. Commissioner* [Dec. 41,795(M)], T.C. Memo. 1984-668; and *Wien Consolidated Airlines, Inc. v. Commissioner* [Dec. 31,912], 60 T.C. 13 (1973), *affd.* [76-1 USTC ¶ 9174] 528 F.2d 735 (9th Cir. 1976).

We disagree. First, the cases petitioner cites largely concern parties' obligations under state regulatory law, and are factually distinguishable. Here petitioner's obligation to use the NAIC statutory method to file its annual reports did not "fix" in time or amount the commissions on deferred premium installments. Nor did the regulatory bodies require that petitioner utilize the NAIC statutory method for any other purpose than reporting to those regulatory bodies.

Secondly, although petitioner correctly notes that we have interpreted *Wien Consolidated Airlines, Inc. v. Commissioner, supra*, as requiring us to distinguish between conditions precedent and conditions subsequent in determining whether a liability is fixed (see *Buckeye International, Inc. v. Commissioner, supra* at 380), under these facts, we cannot find that the parties' rights were sufficiently fixed at the contract's inception date so as to allow them a current deduction for the commissions in issue. Even if the prospective cancellation provisions were correctly characterized as a condition subsequent, thus "fixing" the liability, petitioner has not proved that the amounts in question have been reasonably ascertained, and that the condition which could terminate petitioner's liability (cancellation) can be characterized as one unlikely to occur *Wien Consolidated Airlines, Inc. v. Commissioner, supra* at 17.

UNITED STATES TAX COURT

Docket No. 17739-82

THE HOME GROUP, INC., AS AGENT UNDER THE PROVISIONS OF TREASURY REGULATION SECTION 1.1502-77(d) FOR CITY INVESTING COMPANY AND THE CONSOLIDATED GROUP OF WHICH CITY INVESTING COMPANY WAS THE COMMON PARENT,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed on January 15, 1987, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner as follows:

1968	$ 293.00
1969	$19,774,733.00
1970	$ 1,199,830.00

(Signed) Joel Gerber
Judge.

Entered: AUG 24 1988

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TAX COURT
WASHINGTON
17739-82

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

88-4155

THE HOME GROUP, INC., AS AGENT UNDER THE PROVISIONS OF TREASURY REGULATION SECTION 1.150277(d) FOR CITY INVESTING COMPANY AND THE CONSOLIDATED GROUP OF WHICH CITY INVESTING COMPANY WAS THE COMMON PARENT,

Appellant,

- V. -

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

FILED
MAY 11 1989
ELAINE B. GOLDSMITH, CLERK
UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the eleventh day of May one thousand nine hundred and eighty-nine.

Present: HON. JAMES L. OAKES, Ch. J.
HON. WILLIAM H. TIMBERS, C.J.
HON. AMALYA L. KEARSE, C.J.

Appeal from the United States Tax Court.

This cause came on to be heard on the transcript of record from the United States Tax Court, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the Judgment of said Tax Court be and it hereby is affirmed in accordance with the opinion of this court with costs to be taxed against the appellant.

ELAINE B. GOLDSMITH,
Clerk

/s/ Arthur Heller
By: ARTHUR HELLER
Deputy Clerk

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

Docket No. 88-4155

THE HOME GROUP, INC., AS AGENT UNDER THE PROVISIONS OF TREASURY REGULATION SECTION 1.1502-77(d) FOR CITY INVESTING COMPANY AND THE CONSOLIDATED GROUP OF WHICH CITY INVESTING COMPANY WAS THE COMMON PARENT,

Petitioner-Appellant,

-v.-

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

FILED
JUL 27 1989
ELAINE B. GOLDSMITH, CLERK
UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 27th day of July one thousand nine hundred and eighty-nine.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the Appellant THE HOME GROUP, INCORPORATION.

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in

regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

Elaine B. Goldsmith
Clerk

/s/ by Kathleen Browner
Deputy Clerk